WESTPAC WEEKLY ECONOMIC COMMENTARY

Differing views.

23 May 2022


Mount Cook buttercup

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From a fiscal point of view, Budget 2022 was in line largely with our and market expectations. Even the key new initiative – a 'cost of living relief' package – was essentially as we predicted. However, there were some puzzling aspects to the Treasury's economic forecasts, which will provide an interesting contrast with the Reserve Bank's views later this week.

For the record, Budget 2022 showed that the Government's accounts remain in good shape. While the operating balance isn't expected to return to surplus for another three years, it's on a credible path to get there and the debt requirement looks manageable.

The books also fell well within the new fiscal rules that the Government set out a few weeks ago. The key measure – running an operating surplus of between 0% and 2% in normal times – is met by 2025 or essentially as the books recover from the Covid hit. The other key metric – the net debt ceiling of 30% of GDP – is met over the full forecast period.

But it's still early days for this new fiscal framework. While this year's Budget conforms with the new rules, it doesn't necessarily guarantee that future Budgets will. For example, the multi-year approach to funding allocations in areas such as Health, Natural Resources and Justice means that a large part of the new spending allowance for next year's Budget has already been pre-allocated. That implies that other departments' funding demands will be squeezed into a tighter cap than otherwise. We'll find out next year whether the Government holds to that.

In this high inflation environment, getting value out of new Government spending is particularly challenging. There's a risk that even large increases in funding may not lead to the delivery of more public services, and instead might just add to cost structures. The difficulty of finding more workers to deliver those services is a particular challenge when the unemployment rate is already at a record low. The resumption of skilled migrant inflows will help over the next few years, but the demands on the workforce will extend beyond skilled roles, plus there's no guarantee that migrants will arrive, nor skilled Kiwis won't simply up and leave.

In terms of the Budget's impact on the economy, there are no major implications for our forecasts. The details of this Budget were signalled well in advance, at least in terms of the dollar amounts, and were already captured in our forecasts. The nature of the announced spending isn't obviously more or less stimulatory than we expected. The cost-of-living relief package will help to shore up consumer spending through the middle of this year, but the effects will be quite short-lived.

The question of whether the Government is adding to or detracting from economic growth has never been straightforward to measure, and even less so in the Covid era. The elevated level of Government spending over the past two years was largely due to wage subsidies and business support payments filling the income gap during Covid lockdowns. In that sense, it was not a 'stimulatory' mix of policies. And by the same reasoning, the fact that the Government doesn't expect to be making those payments in the year ahead – because it doesn't expect to be imposing lockdowns – doesn't mean that the overall policy mix is 'contractionary'.

The economic forecasts that underpinned the Budget were quite different from our views in some important ways. Indeed, the Treasury painted a surprisingly grim picture, with persistently high inflation, a sharp slowdown in growth, rising unemployment, and a Reserve Bank seemingly unable to meet its targets. This view perhaps warrants more scrutiny than just treating it as part of the backdrop to the Budget.

The main surprise for us was that the Treasury's forecasts showed inflation lingering above the RBNZ's target band until 2025. Notably, that's not due to oil prices, which the Treasury assumes will ease back over the coming years. In other words, the Treasury assumes that ex-fuel inflation will continue to sizzle away for years to come.

There's no denying that inflation pressures are strong, and we also expect an extended period of high inflation. However, the magnitude and persistence of the inflation pressures that the Treasury forecasts seem overdone to us, especially given the related downturn in the labour market and economic activity that they're also forecasting.

Importantly, this raises questions about how the Treasury expects the RBNZ to respond to the current inflation upswing. In the face of the strong and persistent domestic inflation pressures that the Treasury is forecasting, we would expect the central bank to be hiking rates much more aggressively than is assumed in the Budget. Strangely, the Treasury forecasts include no such ramp-up in the monetary policy response.

This raises related risks for the Government's forecasts on two key fronts. First, if inflation is not as strong as the Treasury expects, nominal revenue growth could be lower than the Government is anticipating. Conversely, if inflation really is as strong as the Treasury is expecting, we could see even larger interest rate increases and a deeper slowdown in activity.

The RBNZ will be offering its own take on inflation in Wednesday's *Monetary Policy Statement*. A 50 basis point increase in the OCR to 2.00% is widely expected, along with a signal of more tightening to come. The RBNZ recently adopted a new tactic, arguing that strong action early on will reduce the risk of having to take interest rates even higher in the future. The bottom line, though, is that the RBNZ needs to present a set of forecasts that have inflation returning to the target over the medium term, so both the speed and extent of projected interest rate hikes will have to flow from that.

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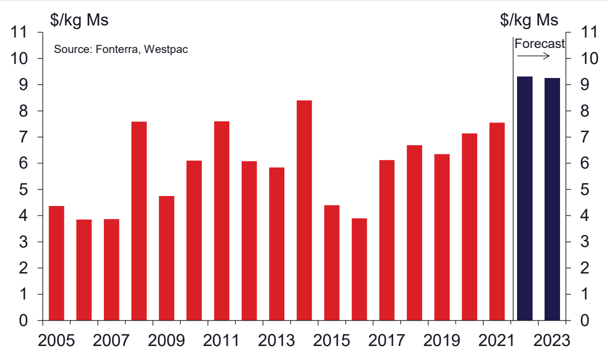
Chart of the week

Last week we trimmed our 2021/22 milk price forecast by 20 cents to $9.30/kg. The downgrade follows the recent dive in dairy auction prices stemming from the Omicron outbreak in China. However, we are sticking with our 2022/23 forecast of $9.25/kg. We still expect this dip in Chinese demand will prove temporary as Covid restrictions will eventually ease. Later this week, Fonterra will release its opening forecast range for 2022/23. We expect them to open with a wide range (of plus or minus 75 cents), with the midpoint at or near our forecast.

Farmgate milk prices

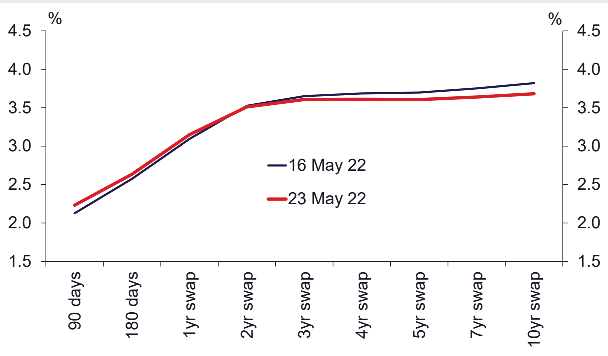


Fixed vs floating for mortgages

Wholesale interest rates remain above our forecast of a 3.5% peak in the Official Cash Rate this year. That suggests to us that there is no cost advantage to fixing for longer terms.

While a one-year mortgage rate is likely to rise further in the year ahead, fixing and rolling for this term is likely to produce a lower borrowing cost on average over the next few years. Longer fixed terms would be more suited to those who want certainty in their repayments.

NZ interest rates



The week ahead

NZ Q1 retail spending (volumes)

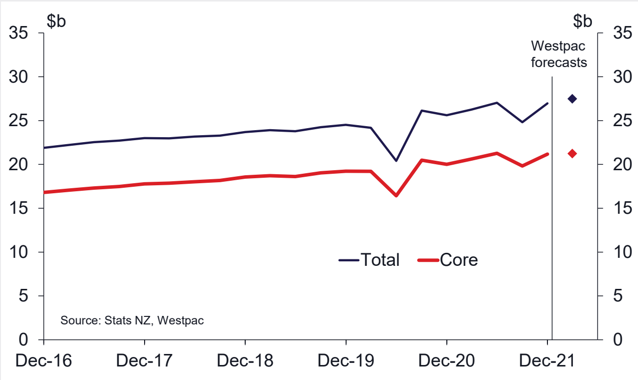
May 24, Last: +8.6%, Westpac f/c: +2.2%

Retail spending rebounded in the December quarter, rising by 8.6%. That almost completely reversed the large Delta-related drop in the previous quarter. The rebound in spending was heavily centred on durable items, while spending in the hospitality sector remained weak.

We're forecasting a 2.2% rise in spending volumes in the March quarter. Much of that rise related to a lift in new car sales, with households rushing to beat the price change for less energy efficient vehicles.

Spending in core categories (excl. fuel and vehicles) is expected to grow by a more modest 1%. While spending has been picking up, increases in the prices of necessities like food and fuel have squeezed discretionary spending. Hospitality spending also remained modest in the early part of the year.

NZ retail spending volumes



RBNZ Monetary Policy Statement

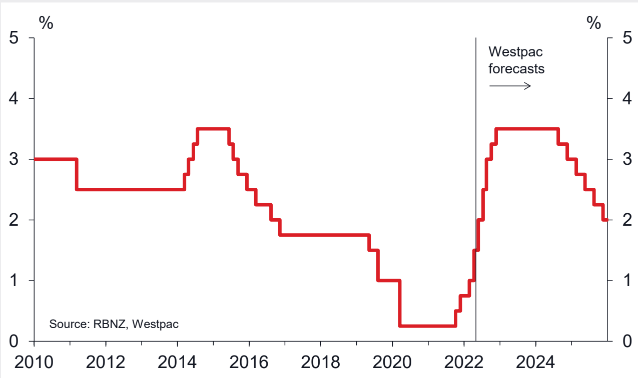
May 25, last: 1.50%, Westpac f/c: 2.00%, Market f/c: 2.00%

We expect the Reserve Bank to raise the Official Cash Rate by another 50 basis points to 2.00% at the May Monetary Policy Statement. We also expect the RBNZ to provide a clear signal that there is more tightening to come.

The RBNZ has come to the conclusion that stronger action early on will reduce the need for an even more painful peak in interest rates in the future. That prompted them to raise the cash rate by 50 bps in April, opening the door for further large increases at future meetings.

We think that recent developments will leave the peak in the RBNZ's OCR forecasts close to the 3.4% peak that was projected in February. However, with a faster pace of tightening, that peak will be reached sooner.

RBNZ Official Cash Rate



Aus Q1 construction work

May 25, Last: –0.4%, WBC f/c: 0.5%
Mkt f/c: 0.9%, Range: –2.0% to 3.5%

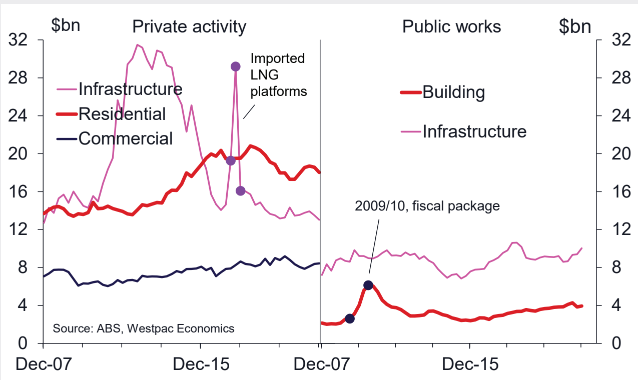
Construction activity advanced in 2021, with strength in Q1 and Q2, supported by substantial policy stimulus, notably: record low interest rates; the HomeBuilder program; and additional public works.

The delta lockdowns hit construction work in NSW during Q3, –7.4%, and Victoria in Q4, –5.5%, punctuating the uptrend in work. Nationally, work fell by –1.2% and –0.4% in Q3 and Q4.

Roll forward to Q1 and disruptions continued. The omicron wave hit in the January holiday month, then wet weather and flooding in NSW and Qld – acting to temper the boost from the post delta reopening.

Our Q1 forecast is 0.5%, with considerable uncertainty. This factors in outcomes which are broadly flat to mildly positive across each of the broad segments (housing, commercial building, infrastructure and public works). By state, potential declines in NSW and Qld are offset by the reopening bounce in Victoria, and gains in other states.

Aus construction work by segment



The week ahead

Aus Q1 private business capex

May 26, Last: 1.1%, WBC f/c: 1.1%
Mkt f/c: 1.3%, Range: –1.0% to 3.5%

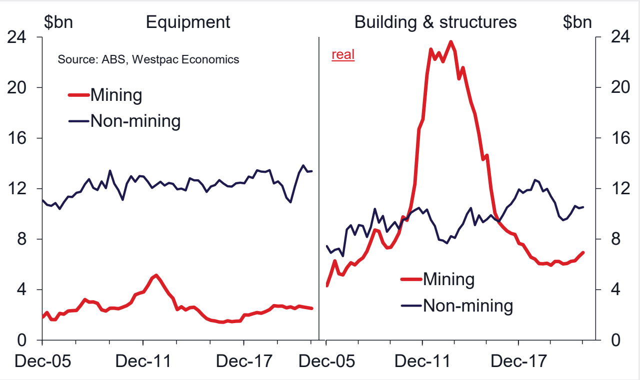
The business mood was generally upbeat throughout 2021 and into 2022, albeit with brief setbacks when virus case numbers spiked.

Firms have increased investment spending, led by equipment, responding to underlying strength in demand, limited spare capacity (mainly in goods sectors) and generous tax incentives.

However, the delta lockdowns over Q3 and Q4 had a material adverse impact, with capex flat over the half year, led lower by a more than 3% decline in equipment.

For Q1, we anticipate a 1.1% lift in capex – to be only 1% higher since mid–2021. The Q1 forecast of +1.1% includes a modest 2% rise in equipment spending and a relatively flat outcome for Building & Structures (possibly impacted by wet weather – although this survey is on an "expenditure basis" rather than actual work done).

Aus Capex by industry by asset



Aus 2022/23 capex plans

May 26, Last: Est 1 $116.7bn t

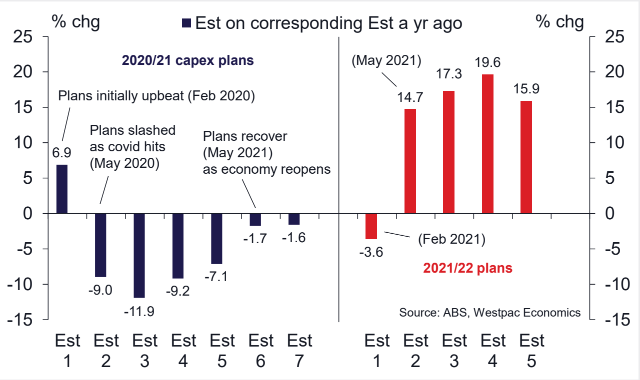
Capex plans point to a sizeable rise in 2021/22, with a further lift in 2022/23. For a given financial year, their are 7 estimates of capex plans, with the figure revised each 3 months, until the outcome.

Of interest, will this latest update, conducted in April and May, confirm a slippage in capex spending – pushing some growth into 2022/23. Disruptions (covid and wet weather), as well as supply headwinds (labour and material shortages) are key constraints.

Three months ago, Est 5 for 2021/22 printed at $140.7bn, 15.9% above Est 5 a year earlier. Potentially, Est 6 prints around $140.4bn. This represents a modest downgrade, with implied growth (we calculate using avg' realisation ratios) moderating from 13.7% to 12%.

Est 1 for 2022/23 printed $116.7bn. That is 10.8% above Est 1 a year ago, a figure we assess to be flattered by weak base effects. Potentially Est 2 prints around $123bn, 8.5% above Est 2 a year ago.

Aus Capex plans



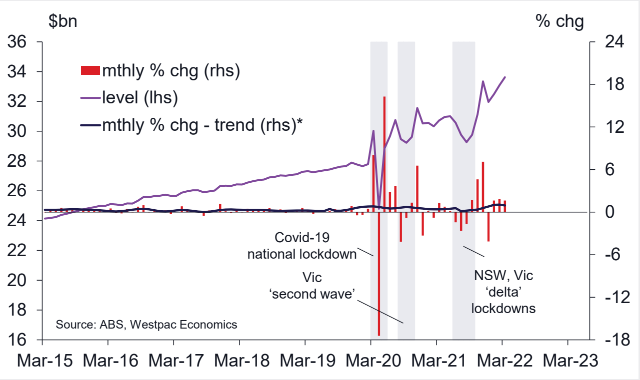
Aus Apr retail trade

May 27, Last: 1.6%, WBC f/c: 1.3%
Mkt f/c: 1.0%, Range: 0.4% to 2.0%re

Retail sales rose 1.6% in March follows similar gains in Feb (1.8%) and Jan (1.6%), lifting annual growth to 9.4%yr. Momentum has been well sustained despite multiple headwinds in early 2022 including the omicron outbreak early in the year; generally lousy weather that has seen severe flooding in parts of Qld and NSW; and a spike in fuel prices following Russia's invasion of Ukraine.

Indicators are a little mixed for April with some additional uncertainty around the impact of Easter holidays and the ongoing post-Covid reopening. Our Westpac Card Tracker suggests the month was another relatively strong one for most retailers with private sector business surveys also showing an improvement. However, consumer sentiment was clearly weakening with fuel and other cost of living price rises potentially having more effect in the month. Overall we expect sales to post a 1.3% gain but with significant risks to either side of the number.

Aus monthly retail sales

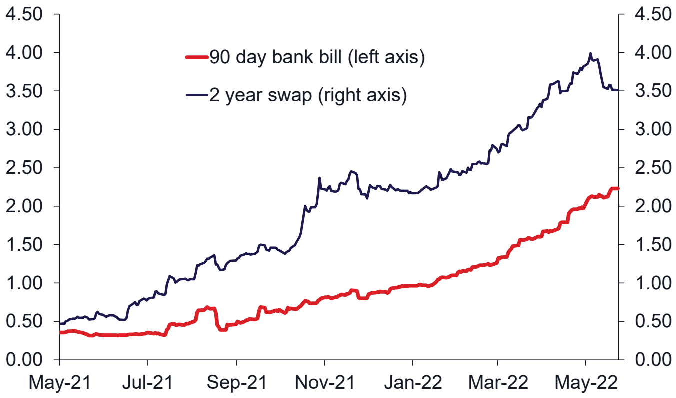


New Zealand forecasts

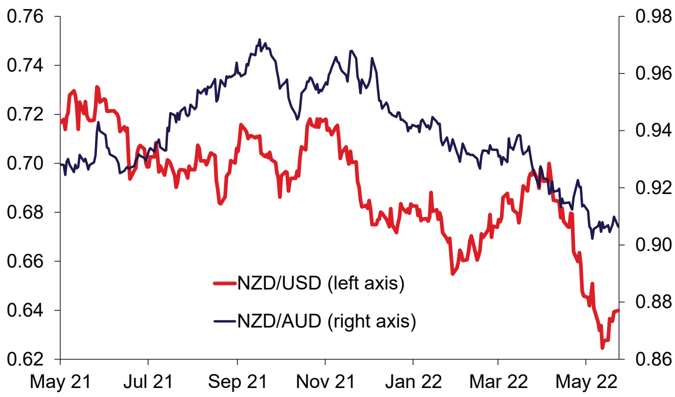
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Dec (a)	Mar	Jun	Sep	2020	2021	2022f	2023f
GDP (Production)	3.0	0.6	0.3	1.0	-2.1	5.6	2.7	3.3
Employment	0.0	0.1	0.3	0.2	0.6	3.5	0.8	0.9
Unemployment Rate % s.a.	3.2	3.2	3.1	3.0	4.9	3.2	3.0	3.3
CPI	1.4	1.8	1.1	1.2	1.4	5.9	4.5	2.7
Current Account Balance % of GDP	-5.8	-5.9	-6.8	-6.9	-0.8	-5.8	-6.6	-5.6

Financial forecasts	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Cash	2.00	3.00	3.50	3.50	3.50	3.50	3.50
90 Day bill	2.70	3.40	3.60	3.60	3.60	3.60	3.60
2 Year Swap	4.00	4.00	3.90	3.70	3.50	3.30	3.10
5 Year Swap	4.10	4.00	3.90	3.70	3.50	3.35	3.20
10 Year Bond	3.80	3.70	3.50	3.30	3.20	3.10	3.00
NZD/USD	0.65	0.67	0.69	0.70	0.71	0.72	0.72
NZD/AUD	0.90	0.91	0.91	0.91	0.91	0.91	0.90
NZD/JPY	83.9	85.8	86.9	87.5	88.0	87.2	87.1
NZD/EUR	0.61	0.62	0.63	0.63	0.63	0.63	0.63
NZD/GBP	0.52	0.53	0.54	0.55	0.55	0.54	0.54
TWI	71.3	72.6	73.8	74.0	74.4	74.4	74.6

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 23 May 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	1.50%	1.50%	1.50%
30 Days	1.92%	1.77%	1.59%
60 Days	2.08%	1.95%	1.78%
90 Days	2.23%	2.12%	1.96%
2 Year Swap	3.51%	3.91%	3.72%
5 Year Swap	3.61%	4.10%	3.83%

NZ foreign currency mid-rates as at 23 May 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6399	0.6352	0.6599
NZD/EUR	0.6055	0.6024	0.6153
NZD/GBP	0.5127	0.5147	0.5192
NZD/JPY	81.83	83.28	84.58
NZD/AUD	0.9064	0.9066	0.9227
TWI	71.45	71.37	72.99

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 23					
Aus	RBA Assist' Governor Financial Mkts	–	–	–	Kent, speaking at KangaNews Summit at 9:05am.
UK	May Rightmove house prices	1.6%	–	–	Demand to soften as rate hikes take effect.
US	Apr Chicago Fed activity index	0.44	–	–	Elevated cost pressures are a key concern for manufacturers.
	Fedspeak	–	–	–	Bostic.
Tue 24					
NZ	Q1 real retail sales	8.6%	–	2.2%	Boost from vehicle sales, core spending more moderate.
Eur	May S&P Global manufacturing PMI	55.5	55.0	–	Russia–Ukraine and rising cost pressures...
	May S&P Global services PMI	57.7	58.1	–	... are a key risk to European manufacturing and services.
UK	May S&P Global manufacturing PMI	55.8	–	–	The UK are better positioned to weather headwinds...
	May S&P Global services PMI	58.9	–	–	... but a sharp slowdown in activity is still coming.
US	May S&P Global manufacturing PMI	59.2	57.9	–	Continues to point to robust momentum in both sectors...
	May S&P Global services PMI	55.6	55.2	–	... although price pressures are an ongoing risk.
	May Richmond Fed index	14	9	–	Sourcing materials and labour still a challenge.
	Apr new home sales	–8.6%	–1.7%	–	Rising mortgage rates beginning to slow sales activity.
	Fedspeak	–	–	–	George.
Wed 25					
NZ	RBNZ policy decision	1.50%	2.00%	2.00%	RBNZ rushing to get ahead of the rise in infl expectations.
Aus	Q1 construction work done	–0.4%	0.9%	0.5%	Reopening bounce tempered by weather disruptions.
	RBA Assist' Governor Economic	–	–	–	Ellis, speaking at UDIA 2022 conference at 9:45am.
US	Apr durable goods orders	1.1%	0.6%	–	Supply issues are still a headwind.
	FOMC May meeting minutes	–	–	–	Focus on discussions of the path for policy in 2022.
Thu 26					
Aus	Q1 private new capital expenditure	1.1%	1.3%	1.1%	Up on equipment spending. Construction wet weather impacts.
	2022/23 capex plans, AUDbn	116.7	–	–	Disruptions – likely see some slippage of growth into 2022/23.
US	Q1 GDP, annualised	–1.4%	–1.3%	–	A very small revision expected in second estimate for Q1.
	Initial jobless claims	218k	–	–	To remain at a low level.
	Apr pending home sales	–1.2%	–1.8%	–	Demand is cooling amid higher rates.
	May Kansas City Fed index	25	–	–	Manufacturing outlook still positive but fragile.
Fri 27					
NZ	May ANZ consumer confidence	84.4	–	–	Cost of living concerns continuing to weigh on sentiment.
Aus	Apr retail sales	1.6%	1.0%	1.3%	Sustained solid momentum through Q1.
Chn	Apr industrial profits ytd %yr	8.5%	–	–	Profit growth will build as Covid-19 disruptions fade.
Eur	Apr M3 money supply %yr	6.3%	–	–	Credit data also due. Liquidity ample for economy.
US	Apr wholesale inventories	2.3%	–	–	Businesses striving to lift productivity against supply issues.
	Apr personal income	0.5%	0.5%	–	Purchasing power is an ongoing concern...
	Apr personal spending	1.1%	0.6%	–	... but the lift in services spending is a clear positive.
	Apr PCE deflator	0.9%	0.2%	–	PCE inflation looks to have crested...
	Apr core PCE deflator	0.3%	0.3%	–	... but price pressures will only slowly abate through 2022.
	May Uni. of Michigan sentiment	59.1	59.1	–	Consumer optimism hinges on the inflation outlook.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.2	4.7	4.5	3.5
CPI inflation %yr	1.8	1.8	0.9	3.5	5.6	2.6
Unemployment rate %	5.0	5.2	6.8	4.7	3.2	3.4
Current account % of GDP	-2.1	0.7	2.6	3.5	1.9	-1.8
United States						
Real GDP %yr	3.0	2.2	-3.5	5.7	2.6	1.8
CPI inflation %yr	2.4	1.9	1.3	7.1	3.7	2.3
Unemployment rate %	3.9	3.7	8.1	5.4	3.7	4.1
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	0.3	-4.8	1.8	2.2	1.4
Euro zone						
Real GDP %yr	1.9	1.3	-6.6	4.9	2.2	1.5
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.2	3.7	0.0
China						
Real GDP %yr	6.7	5.8	2.3	8.1	5.3	5.5
East Asia ex China						
Real GDP %yr	4.4	3.7	-2.4	4.2	4.5	4.7
World						
Real GDP %yr	3.6	2.8	-3.3	5.5	3.4	3.3

Forecasts finalised 6 May 2022

Interest rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Australia								
Cash	0.35	0.75	1.25	1.75	2.00	2.25	2.25	2.25
90 Day BBSW	1.04	0.95	1.45	1.95	2.20	2.45	2.45	2.45
10 Year Bond	3.30	3.30	3.15	2.90	2.65	2.50	2.40	2.30
International								
Fed Funds	0.875	1.375	2.125	2.625	2.625	2.625	2.625	2.625
US 10 Year Bond	2.84	2.90	2.80	2.60	2.40	2.30	2.20	2.10

Exchange rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
AUD/USD	0.7020	0.72	0.74	0.76	0.77	0.78	0.79	0.80
USD/JPY	127.68	129	128	126	125	124	122	121
EUR/USD	1.0572	1.05	1.07	1.09	1.11	1.13	1.14	1.15
GBP/USD	1.2453	1.23	1.24	1.26	1.28	1.30	1.32	1.34
USD/CNY	6.7186	6.65	6.50	6.35	6.25	6.20	6.15	6.15
AUD/NZD	1.0999	1.11	1.10	1.10	1.10	1.10	1.10	1.11

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